

## Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 EB-04 TRSE-00 NSCE-00 SP-02  
L-01 INR-05 CIAE-00 NSAE-00 OMB-01 SSO-00 EURE-00  
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FM AMEMBASSY LISBON  
TO SECSTATE WASHDC IMMEDIATE 3138

C O N F I D E N T I A L SECTION 1 OF 2 LISBON 7377

LIMDIS

DEPT PLEASE PASS TREASURY FOR SYVRUD

E.O. 11652: GDS  
TAGS: EGEN EFIN PO  
SUBJECT: RECENT GOP AUSTERITY MEASURES

REF: (A) LISBON 7216, (B) STATE 225901

SUMMARY: DURING MEETING SEPTEMBER 21, MINISTER OF PLANNING SOUSA GOMES REITERATED GOP'S WILLINGNESS TO ADOPT ADDITIONAL MEASURES THAT MAY BE NEEDED TO IMPROVE ECONOMIC SITUATION. ALTHOUGH CONCERNED THAT POLICIES PROPOSED BY IMF MIGHT OVERLY DEPRESS THE ECONOMY AND LEAD TO MAJOR SOCIAL AND POLITICAL UNREST, HE AGREED THAT PORTUGAL HAD NO CHOICE BUT TO CONCLUDE SECOND TRANCHE AGREEMENT. HE CLEARLY BELIEVES, HOWEVER, THAT IT MAY BE POSSIBLE TO CONTINUE OBTAINING LARGE EXTERNAL CREDITS THAT WOULD FINANCE ECONOMIC EXPANSION WHILE GOP RESOLVES BALANCE OF PAYMENTS DISEQUILIBRIUM. HIS UNREALISTIC OPTIMISM REFLECTS HIS DEARTH OF EXPERIENCE WITH RECENT GOP EFFORTS TO SECURE FOREIGN CREDITS. WE TRIED TO SET HIM STRAIGHT. WE BELIEVE, HOWEVER, THAT A FORCEFUL PRESENTATION OF IMF AND USG POSITIONS DURING MINISTER'S FORTHCOMING WASHINGTON VISIT IS IN ORDER. WE RECOMMEND THAT OFFICIALS  
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WITH WHOM HE MEETS PROVIDE A DIRECT, REALISTIC ASSESSMENT OF FUTURE FOREIGN ASSISTANCE POSSIBILITIES. SOUSA GOMES HAS REQUESTED THAT WE SEEK AN APPOINTMENT FOR HIM WITH SECRETARY BLUMENTHAL. WE RECOMMEND THAT THIS APPOINTMENT BE GRANTED. END SUMMARY.

1. ECON COUNSELOR AND I MET WITH MINISTER OF PLANNING

SOUSA GOMES SEPTEMBER 21 TO PURSUE MY EARLIER CONVERSATION WITH PRIME MINISTER SOARES (REF A). IN RESPONSE TO MY QUESTION, SOUSA GOMES STATED HE HAD HAD PRELIMINARY DISCUSSION WITH IMF MISSION CURRENTLY IN LISBON. THAT CONVERSATION FOCUSED ON FOUR POINTS: INTEREST RATE, EXCHANGE POLICY, GOP 1978 BUDGET AND PORTUGAL'S IMPORT RESTRAINT MEASURES. ON FIRST TWO POINTS, IMF MISSION ALLEGEDLY INDICATED ITS RELATIVE SATISFACTION WITH GOP DECISIONS. IN ESSENCE, THE MINISTER CLAIMED, MISSION SEEMED DISPOSED TO WAIT UNTIL FEBRUARY 1978 TO SEE IF THESE POLICIES WERE ADEQUATE OR WHETHER FURTHER MEASURES WOULD BE NECESSARY. AS TO THE BUDGET, SOUSA GOMES FELT GOP COULD ACHIEVE TARGETS IMF MISSION SEEMED TO BE RECOMMENDING. HE ADMITTED, HOWEVER, BEING SERIOUSLY DISTURBED BY THE MISSION'S INDICATION THAT MEANINGFUL SECOND TRANCHE NEGOTIATIONS COULD NOT BEGIN UNTIL AFTER NATIONAL ASSEMBLY HAS APPROVED 1978 BUDGET. SINCE THIS LEGISLATIVE PROCESS WILL LAST UNTIL LATE DECEMBER, SECOND TRANCHE NEGOTIATIONS WOULD NOT BEGIN UNTIL EARLY 1978. THIS TIMING WOULD GREATLY DELAY DRAW-DOWN OF BILATERAL LOANS NOW BEING NEGOTIATED AND, THEREBY, DISRUPT COMPLETELY GOP'S FOREIGN EXCHANGE PROJECTIONS. FINALLY, HE TOOK EXCEPTION TO FUND'S RECOMMENDATION TO ELIMINATE IMPORT BARRIERS, E.G., TAX SURCHARGES AND PRIOR DEPOSITS, ASSERTING THAT EASING THESE POLICIES WOULD AGGRAVATE BALANCE OF PAYMENT DIFFICULTIES. IN FACT, GOP WAS PLANNING SOME SLIGHT ADDITIONAL BARRIERS, E.G., HIGHER

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PRIOR IMPORT DEPOSITS.

2. DESPITE HIS RELATIVELY MILD REACTION TO ALLEGED IMF RECOMMENDATIONS, THE MINISTER CLEARLY WAS BOTHERED BY PROSPECTS OF HAVING TO PURSUE AN "ORTHODOX" AND "POLITICALLY UNREALISTIC" IMF PROGRAM. HE CONCEDED THAT GOP MUST, AND WILL, CONCLUDE SECOND TRANCHE AGREEMENT, BUT HE COULD NOT SEE WHAT ADDITIONAL MEASURES GOP COULD TAKE TO ACHIEVE BETTER ECONOMIC RESULTS. FURTHER DEVALUATION, HE BELIEVES, WOULD PRODUCE NO SIGNIFICANT BENEFITS BECAUSE ADDITIONAL IMMEDIATE EXPORT POTENTIAL IS NON-EXISTENT. BESIDES, PORTUGUESE EXPORTS ARE APPARENTLY HIGHLY COMPETITIVE ALREADY. ON THE OTHER HAND, DEVALUATION WOULD HAVE SERIOUS NEGATIVE EFFECTS BY ACCELERATING INFLATION, SPARKING DISRUPTIVE SOCIAL REACTIONS AND IMPEDING EFFECTIVE WAGE CONSTRAINTS IN 1978. AS FOR INTEREST RATES, LATEST INCREASES ARE ALREADY CAUSING NUMEROUS COMPANIES TO WORSEN DURING OCTOBER. FURTHER INCREASES WOULD JEOPARDIZE THEIR SURVIVAL AND DISCOURAGE INVESTMENTS WITHOUT SIGNIFICANTLY AFFECTING BALANCE OF PAYMENTS. SOUSA GOMES STRESSED THAT HE WAS PREPARED TO LISTEN TO IMF ARGUMENTS AND TO CHANGE HIS POSITION IF

THESE ARGUMENTS ARE PERSUASIVE. HE FEARS, HOWEVER, THAT IMF POLICIES WOULD PREVENT ECONOMIC GROWTH OVER THE SHORT TO MEDIUM TERM, AND PERHAPS FORCE THE ECONOMY INTO A LONG DOWNWARD ECONOMIC SPIRAL. THE RESULTING SOCIAL UNREST, HE AFFIRMED, WOULD END ALL POSSIBILITY OF MAINTAINING A DEMOCRATIC SYSTEM. THE MINISTER HAS AN ALTERNATIVE SOLUTION IN MIND.

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O 221615Z SEP 77

FM AMEMBASSY LISBON

TO SECSTATE WASHDC IMMEDIATE 3139

C O N F I D E N T I A L SECTION 2 OF 2 LISBON 7377

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3. SOUSA GOMES BELIEVES THAT PORTUGAL'S REVOLUTIONARY PROCESS HAS LEFT THE ECONOMY IN A SHAMBLES. RESURRECTING THE OFTEN-HEARD COMPARISON WITH POST WORLD WAR II EUROPE, HE APPEALED FOR A FIVE YEAR RECONSTRUCTION ASSISTANCE PROGRAM FROM THE WESTERN WORLD. ALTHOUGH THE GOP MUST ADOPT AUSTERITY MEASURES, SUCH MEASURES COULD SUCCEED ONLY IF EXTERNAL FINANCIAL SUPPORT IS AVAILABLE TO PERMIT A RELATIVELY SMOOTH, MEDIUM TERM TRANSITION. HE REQUESTED THAT USG CONTINUE THE LEVEL OF ASSISTANCE IT HAS OFFERED SINCE 1975. HE EXPRESSED CONFIDENCE THAT WESTERN EUROPE WOULD BE SYMPATHETIC TO A REQUEST FOR SUCH ASSISTANCE. HE WAS PARTICULARLY SANGUINE ABOUT SUBSTANTIAL ADDITIONAL MEDIUM TERM AND LONGER-TERM FINANCIAL SUPPORT FROM GERMANY IN THE FORM OF PROJECT ASSISTANCE AND BALANCE OF PAYMENTS SUPPORT. THIS CONFIDENCE, HE CLAIMED, STEMMED FROM RECENT EXPRESSIONS OF SUPPORT FROM GERMAN OFFICIALS, AND PARTICULARLY FROM MEMBERS OF THE SPD. AS FURTHER PROOF HE CITED THE EUROPEAN COMMON MARKET'S REPORTED DESIRE TO ESTABLISH AN ASSISTANCE PROGRAM FOR SOUTHERN EUROPE.

4. WE REPEATEDLY AND FRANKLY EXPRESSED OUR DISAGREEMENT  
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WITH SOUSA GOMES' CONCEPTS. WE NOTED THAT A DEVALUATION WAS DESIGNED TO HAVE ITS PRINCIPAL IMMEDIATE EFFECT ON THE CAPITAL ACCOUNT, THE ACCOUNT WHICH OFFERS THE ONLY GENUINE SHORT TERM POSSIBILITY OF SIGNIFICANTLY EASING PORTUGAL'S BALANCE OF PAYMENTS DIFFICULTIES. WE EMPHASIZED THAT A REASONABLE DEVALUATION COULD DISCOURAGE CAPITAL FLIGHT, PROMOTE NEW FOREIGN INVESTMENT AND ENCOURAGE PRIVATE FOREIGN BANK LOANS. SOUSA GOMES ACKNOWLEDGED THESE POSSIBILITIES, BUT EXPRESSED DOUBT THAT THE VOLUME OF CAPITAL FLOW WOULD BE SUFFICIENT. SIMILARLY, HE SHOWED A CONFUSED PERCEPTION OF INTEREST RATE POLICY IMPACT ON CAPITAL FLOWS. MOST OF OUR REMARKS, HOWEVER, WERE DIRECTED TOWARD CHANGING GOMES' BASIC EXPECTATION OF CONTINUED LARGE SCALE FOREIGN ASSISTANCE, STRESSING THAT PORTUGAL'S FIRST PRIORITY MUST BE RESOLUTION OF THE BALANCE OF PAYMENTS DEFICIT. WE EMPHASIZED THAT THE NATION COULD NOT EXPECT THE TYPE OF FOREIGN ASSISTANCE IT HAD RECEIVED IN THE PAST. THE ARGUMENTS HE WAS MAKING HAD ALREADY BEEN USED TO GET THE MULTILATERAL LOAN UNDERWAY. THE AMOUNTS AND PERIODS WERE REASONABLE. IT WAS NOW PORTUGAL'S TURN AT BAT. THE GOP HAD TO DEAL REALISTICALLY WITH ITS PROBLEMS, TAKING THE MEASURES NEEDED TO BALANCE ITS DESIRES WITH ITS REAL CAPACITY. IF HE WAS CONVINCED THIS WOULD RESULT IN POLITICAL DISASTER, THEN THE PROBLEM HAD TAKEN ON A NEW DIMENSION AND OUR DIALOGUE SHOULD BE ESCALATED TO THE PRESIDENT AND PRIME MINISTER, BOTH OF WHOM HAD HAD THE LIMITATIONS OF OUR ASSISTANCE PROGRAMS EXPLAINED TO THEM AT THE OUTSET.

5. COMMENT: SOUSA GOMES CONFIRMED WHAT WE HAD HEARD INDIRECTLY ABOUT HIM, I.E., HE HAS HAD LITTLE EXPOSURE TO THE DIMENSIONS OF THE NATION'S FINANCIAL PROBLEMS AND IS OVERLY OPTIMISTIC ABOUT OBTAINING MASSIVE FOREIGN ASSISTANCE.  
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IT IS IMPERATIVE, THEREFORE, THAT THE IMF CLEARLY AND FORCEFULLY PRESENT ITS PROGRAM. DURING HIS WASHINGTON VISIT TO ATTEND THE WORLD BANK/IMF ANNUAL MEETING, SOUSA GOMES MUST BE INFORMED BLUNTLY AS TO THE PROSPECTS OF FURTHER ASSISTANCE. IN ADDITION, IMF SHOULD BE PREPARED TO SUGGEST SPECIFIC MEASURES AND TO EXPLAIN THEIR EXPECTED IMPACT. SOUSA GOMES HAS SHOWN AN ABILITY TO ADAPT TO CHANGING REQUIREMENTS. HOPEFULLY, FRANK

DISCUSSIONS IN WASHINGTON WILL CONVINCE HIM OF THE NEED TO DO SO AGAIN.

6. THE MINISTER'S CONFIDENCE IN INCREASED GERMAN ASSISTANCE WAS A SURPRISE. EMBASSY WOULD APPRECIATE ANY INFORMATION WASHINGTON MAY HAVE ON THESE ALLEGED GERMAN PROMISES. WE WILL PURSUE THIS ISSUE WITH GERMAN EMBASSY IN LISBON.

7. ACTION REQUESTED: MINISTER SOUSA GOMES EXPRESSED A DESIRE TO MEET WITH SECRETARY BLUMENTHAL IN ORDER TO PRESENT HIS CASE. WE RECOMMEND THAT THIS MEETING BE SCHEDULED, IF POSSIBLE, IN ADDITION TO APPOINTMENTS BEING MADE WITH UNDER SECRETARIES COOPER AND SULLIVAN. UNDOUBTEDLY, A STATEMENT BY SECRETARY BLUMENTHAL TO SOUSA GOMES WILL HAVE A MAJOR IMPACT IN REFORMULATING THE LATTER'S OUTLOOK. PLEASE ADVISE.  
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